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David S. Guzy, Chief
Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
U.S. Department of the Interior
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Denver, CO 80225-0165

Comments on MMS Supplementary Proposal on
Valuation of Crude Oil Produced on Federal Leases
30 CFR 206, 63 FR 6113 (February 6, 1998)

Dear Mr. Guzy:

The Council of Petroleum Accountant's Societies (COPAS) appreciates the opportunity to comment on the MMS proposed rulemaking governing oil valuation for federal leases. COPAS members have extensive experience with Royalty Management Program (RMP) rules and handle royalty valuation, transportation and processing allowances, adjustments, bills, audits, and other royalty matters on a regular basis. Therefore, we believe our comments will be beneficial in improving RMP processes for both the MMS and industry.

COPAS comments address issues in the six parts as follows: (1) General Comments, (2) Definitions, (3) Valuation Determination, (4) Administrative Burdens, (5) Audit Compliance and (6) Lack of Certainty. These comments are intended to supplement comments made by COPAS on previous versions of this proposed rule.

General Comments

COPAS is disappointed with the publication of the MMS' supplementary rule. The supplementary rule did not sufficiently address the industry's central concerns with the proposed rule. COPAS believes that this rule should not be finalized and that the MMS should undertake a fundamental revision of its proposal in order to eliminate the vague and uncertain requirements that are certain to result in costly, lengthy audits and litigation.

Definitions

COPAS is concerned with several definitions proposed by MMS. Some of the concerns involve defined terms or previously defined terms with significant changes to the current definition. In other cases, the definition of the term itself has not changed, but the definition is given new meaning in context of the proposed rule as a whole. In any case, it is critical to have clear and concise definitions which both MMS and lessees understand in order to achieve certainty. COPAS offers the following comments on the definition section of the proposed rule.

Affiliate - COPAS strongly objects to the changes made by MMS to the definition of affiliate at this late stage of the rulemaking process. At a minimum, MMS should reinstate the control language in the 1988 regulations, and give lessees the option to refute the presumption of control for interests of 10% to 50%. COPAS also believes the reference to partnerships and joint ventures should be deleted. Under normal operating circumstances, lessees do not have access to the records of entities created by partnerships or joint ventures with other companies. Also, the reference to partnerships and joint ventures could create confusion as to whether the affiliation test applies to the property, field, or corporate level.

COPAS recommends MMS use the definition of control used by BLM and codified at 43 CFR 3400.0-5(rr)(3) (51 FR 43910, December 5, 1986) as the basis for its definition of affiliate. Under this definition, ownership of less than 20% creates a presumption of noncontrol, ownership of 20% to 50% creates a presumption of control, and ownership in excess of 50% constitutes control. MMS received many comments regarding the use of the BLM definition during the comment period prior to promulgation of the 1988 regulations, but MMS lowered the percentage from 20% to 10% based on comments from the Indians. This proposed rule would apply only to federal leases, not Indian leases; therefore, COPAS recommends MMS base its definition of affiliate on the BLM definition of control.

Area - Even though the definition of area has not been changed significantly from the definition in the 1988 regulations, the term takes on added importance in light of the benchmarking program proposed for the Rocky Mountain Area. Both MMS and lessees must clearly understand what constitutes an area for both tendering programs and the sale/purchase benchmark. How will lessees know what an area is? This information must be available at the time royalty payments are initially made. Disagreement or confusion over what constitutes an area will only serve to create uncertainty in the valuation process.

Arm's-length contract - The definition of arm's-length contract states the parties must have "opposing economic interests regarding that contract". What circumstances can MMS foresee in which non-affiliated parties would have a contract without opposing economic interests? MMS should either delete or define this phrase.

Competitive crude oil call - Under the definition of competitive crude oil call, the lessee would be required to review the specific language in the contract. However, there may be cases in which the lessee does not have access to the contract. For example, Company A retained a call on the oil produced from a property it sold to Company B. Company B then sold the property to Company C, and Company C is still subject to the call of Company A. Company C may not have access to the original contract between Companies A and B that contains the call provision.

How will MMS determine if a call is competitive or non-competitive in a timely manner? If MMS is allowed to second guess the lessee's determination during an audit years after the month of production, another element of uncertainty will be introduced into the royalty process.

Gross proceeds - COPAS adamantly disagrees with the duty to market language included in the definition of gross proceeds and Section 206.106 of the proposed rule. These comments will not address the specific legal arguments regarding duty to market. However, COPAS generally endorses the comments made by API and IPAA regarding this matter. Another concern of

COPAS regarding the definition of gross proceeds is example (5) which addresses payments made to reduce or buy down the purchase price of oil to be produced in later periods.

Finally, MMS' February 5, 1998 news release stated, "Royalty must be based on the value of production at the lease." The definition of gross proceeds proposed by MMS is written to include gross proceeds accruing to both the lessee and its affiliates. The inclusion of gross proceeds accruing to an affiliate does not lead to value at the lease; instead, the use of affiliate's gross proceeds results in a value in excess of the value at the lease. The reason is that the proposed rule fails to account for the risks and costs incurred by the affiliate downstream of the delivery point. MMS is trying to extract royalty on the value added by the downstream activities without bearing its respective portion of the downstream risks and costs. In order to adhere to its principle to determine the value of production at the lease, MMS must allow downstream costs to be deducted from the gross proceeds accruing to either the lessee or its affiliates.

Market center - According to the definition, market centers will be determined by MMS. COPAS is concerned that industry does not have input in the selection of market centers. Does MMS plan to periodically review and update the list of market centers? Without industry input in the process, MMS may choose to eliminate the market centers it believes reflect low prices. In order to achieve certainty, lessees must know for certain which market centers are applicable at the time royalty payments are initially made. MMS should not be allowed to retroactively add or delete market centers.

MMS-approved publication - MMS states it must approve the publications used to determine NYMEX prices, spot prices, or location differentials. Will the publications be selected at MMS' sole discretion? Can industry recommend that specific publications be approved or disapproved? COPAS believes industry should have input in the publications selected.

Netting - The definition of netting specifically addresses the issue of transportation allowances and the requirement that they be reported as a separate line item on Form MMS-2014. As MMS moves the valuation point further downstream of the lease and attempts to netback to a value at the lease, adjustments other than transportation will be needed. How does MMS intend to handle reporting of location and/or quality differentials between the lease and the aggregation point and between the aggregation point and the market center? Will MMS also require these adjustments to be reported as separate lines on Form MMS-2014? If so, additional reporting will increase the administrative burden of both MMS and lessees. If not, the audit process will be more complicated as the auditors would not be able to tie the reported prices back to market center prices without detailed analysis.

Non-competitive crude oil call - What if the party exercising the call is offering a competitive price? Does the absence of the language specified in the proposal preclude a lessee from paying royalty on the gross proceeds received from the buyer at perhaps the best price available?

Rocky Mountain Area - COPAS proposes changing this term from Rocky Mountain Area to Rocky Mountain Region. Area is a previously defined term, and it may create confusion to use the word again in reference to a specific geographical region. COPAS does not believe the states of Colorado, Montana, North Dakota, South Dakota, Utah, and Wyoming constitute a single area, and using the term Rocky Mountain Area may lead to assumptions that the six states are one area.

Tendering - What does MMS mean by "other geographical/ physical unit"? This phrase should be clarified or deleted from the definition.

Valuation Determination

Arm's-length Sale - Sec. 206.102
COPAS believes that tracing oil sold by an affiliate under an arm's-length contract (ALC) will make federal oil valuation extremely complex and difficult. Oil sold under an affiliate's ALC is very difficult to trace, especially when the oil is often commingled with oil from other sources. Affiliated companies typically do not have systems in place with the capability to trace oil to its ultimate sale. This line of business depends on large quantity purchases of oil that are produced at many differing locations. The exchanging, trucking, pipelining, and sale of these large commingled purchased volumes of oil make it almost impossible to trace this oil from any lease to its ultimate disposition / sale. Information needed from the affiliates for valuation purposes would also be very difficult to get and interpret for royalty payment purposes. Likewise, MMS would have difficulty in tracing volumes of royalty oil produced and this would result in second-guessing the lessee's valuation during the audit process.

Under part c(2)(ii) of this section, the MMS states the lessee's duty to market obligation. COPAS believes this is an over-reaching obligation that has been expanded by the MMS in these regulations. This over-reaching obligation places added responsibilities on the lessor and does not comply with the certainty and simplicity concepts which we both desire in new oil valuation regulations. As written, this over-reaching obligation provides too much latitude to audit personnel for differences in interpretation.

In part c(3), the MMS retains the right to void the terms of an arm's-length exchange agreement if it determines that any arm's-length exchange agreement does not reflect reasonable location or quality differentials. We believe this provides the MMS auditors too much latitude to second-guess lessee's arm's-length agreements and force lessees to value oil under section 206.103.

COPAS also believes that this section does not adequately address situations where a non-operator decides to allow the operator to market his share of production under the terms of the Joint Operating Agreement (JOA). Under the definition of 'Arm's-length contract' and 'person', a lessee may not be allowed to value his oil for royalty purposes under Section 206.102 because the MMS may deem the JOA not to be an arm's-length contract as per the definition of person. If so, many more non-operators may start selling their own share of production, resulting in added administrative efforts for both the lessee and MMS. This would manifest itself in untold number of additional Form MMS 2014 and Form MMS 4415 reports. COPAS would like to see the definitions for "arm's-length contract" and "person" changed to allow for the continued sale of a non-operator's share of production by the operator under the JOA.

Non-Arm's-length Sale - Sec. 206.103 (b)
COPAS supports the use of benchmarks in all areas of the country, not just in the Rocky Mountain Area, as the best determination of value for oil disposed of under non-arm's-length contracts. However, COPAS is disappointed that the MMS rejected the benchmarks as proposed by industry and placed severe restrictions on them.

The following restrictions on the use of benchmarks in the Rocky Mountain Area unnecessarily complicate the valuation process and make it unworkable for many federal lessees.

(1) "If you have an MMS-approved tendering program, the value of production from leases in the area is the highest bid price for tendered volumes. You must offer and sell at least

33-1/3 percent of your production from both federal and non-federal leases in that area under your tendering program. You also must receive at lease 3 bids for the tendered volumes for bidders who do not have their own tendering programs that cover some or all of the same area".

COPAS supports the use of a tendering program as a benchmark, but believes that what MMS has proposed is so restrictive that it is unlikely any lessee would qualify to value oil under the benchmark.

The purpose of a tendering program is to determine market value at the lease. You do not need to receive 3 bids from bidders who do not have tendering program of their own to make that determination. In fact, in some parts of the Rocky Mountain area, lessees may only receive 1 bid. A lessee with a tendering program may request bids from many companies but the lessee has absolutely no control over the number of bids received. The 3-bid restriction that MMS has proposed virtually negates the use of a tendering program as a viable benchmark.

In this benchmark, MMS also states that you must offer and sell at least 33-1/3 percent of your production from both federal and non-federal leases in the area. In the preamble, MMS justifies the 33-1/3 percent by saying that this percentage is made up of the federal royalty interest, a combination of state royalty and tax percents plus 10 percent. COPAS believes that the process used to arrive at the 33-1/3 percent is flawed. If the lease is federal, there is no state royalty or tax interest involved. Likewise, if the lease is a state lease, there is no federal interest involved. COPAS believes there should be a sufficient volume offered to determine market value. However, 33-1/3 percent of the total production from federal and non-federal leases is excessive.

Lastly, MMS states that the value is the highest bid price for tendered volumes. COPAS believes that the value should be based on the weighted average price received for the volumes tendered.

(2) "Value is the volume-weighted average gross proceeds accruing to the seller under you or your affiliates' arm's-length contracts for the purchase or sale of production from the field or area during the production month. The total volume purchased or sold under those contracts must exceed 50 percent of your or your affiliates production...".

COPAS agrees with the use of arms-length purchases and sales as a benchmark, but we believe that 50 percent is too high. Also, there needs to be clarity provided on the field or area concept in order for the lessee to determine that it is applying the benchmark properly.

(3) Value is the average of the daily NYMEX futures settled price at Cushing, Oklahoma, for the light sweet crude oil contract...".

COPAS does not believe this benchmark is workable. There were hundreds of pages of comments to MMS' original proposed rule on why a NYMEX netback in the Rocky Mountain area was not feasible. During the workshops, there was considerable discussion detailing why this netback does not work. The MMS obviously rejected the suggestions made in such discussions as the supplementary proposed rule outlines a netback methodology that is even less workable that what was originally proposed.

Analysis of this benchmark, along with Sections 206.112 and 206.113, indicates that MMS is proposing that a lessee value Rocky Mountain crude oil at a NYMEX value with no location or quality differential unless the lessee has an exchange agreement between the Rocky Mountain Area and Cushing, Oklahoma which has a specific differential. The lessee's only alternative, if he does not have a specific differential, is to request a differential from MMS. It does not appear to COPAS that the MMS can determine this differential. To say this another way, MMS is proposing that royalties on Wyoming Sour be paid on a NYMEX sweet value. Furthermore, this netback still has the other flaws noted in COPAS' previous comments. COPAS simply does not believe that any form of netback to the Rocky Mountain Area from Cushing, Oklahoma is a viable benchmark.

COPAS believes the benchmarks based on the value of production at the lease at the time of production, if properly written, would work for ALL federal production.

Transportation Allowances - 50% Limitation
The 50% limitation on transportation allowances became part of MMS' regulations when valuation was at or near the lease. Since the royalty valuation point in the proposed regulations has, in many cases, been moved to points that may be hundreds of miles downstream of the valuation point under current regulations, the 50% limitation on transportation should be reconsidered. By moving the royalty valuation point, the likelihood of a lessee's transportation costs exceeding 50% is increased significantly. The MMS would then be enjoying the benefits of the higher downstream prices while bearing only a portion of the costs of transporting the production to the valuation point.

MMS has given lessees the option to request the right to exceed the 50% limitation by using Form MMS-4393 along with documentation that the costs were reasonable, actual, and necessary. Yet, the MMS' decision is non-binding and subject to second-guessing years later.

Non-Arm's-Length Transportation - Request to Use Tariffs
MMS has completely eliminated the lessee's option to use FERC or State regulatory agency tariffs in lieu of computing actual costs on non-arm's-length pipelines. Although there is an ongoing dispute over the jurisdictional status of certain OCS oil pipelines, eliminating this option would require lessees to compute actual costs on pipelines that are clearly jurisdictional (i.e. onshore interstate pipelines and State-regulated pipelines). Removing the ability to use tariffs in lieu of actual costs does not make sense. The reason for this option being included in the regulations has not changed since the language was included in the current regulations. In addition to the legal argument, eliminating the option to use tariffs on non-arm's-length pipelines will only increase the audit costs for MMS and lessees, increase lessees' administrative costs, and decrease certainty.

Administrative Burden

Record Keeping
Under this proposed rule record keeping would be an extremely burdensome task. Not only would the producing company have to keep records to support the royalty price paid, but so would the affiliate. This is an added burden for companies in that, historically, the E&P company had to keep records for MMS audit purposes, but the affiliate did not. In today's world when there are many mergers taking place, it will be very difficult, if not impossible, to convince the new affiliate to retain records. Specifics on the Form 2014 and reporting issues follow. The affiliate would not know what records to keep because there is no way to tell what applies to the

original federal lease. This would lead to companies having to retain every single document used to conduct their oil business to satisfy a MMS audit. That would be a tremendous increase in the number of records retained compared with what is required today.

Form MMS 2014

The proposed regulations are unclear as to how location/quality adjustments on sales and quality banks will be reported. Will these adjustments be reported as part of the transportation allowance or as part of the sales value?

The proposed rule will significantly increase direct and indirect administrative burden of both industry and the MMS. As previously mentioned in these comments, the rule contains many uncertainties. These uncertainties, coupled with the mechanics of calculating a royalty value will not only require additional industry resources to comply with the rule, but will also require additional MMS resources to monitor and enforce the rule.

To illustrate, we have enumerated parts of the rule (not all) that significantly contribute to a high cost of compliance. Many of these items highlighted are truly subjective, thus requiring industry interpretation. This interpretation will add to the administrative burden and will precipitate further disputes and costly litigation.

Reporting Valuation - Arm's-Length Contracts

Valuation calculations under the different methodologies, depending on the geographic location and final determination of whether or not a transaction is arm's length, will require new or modified computer systems. Systems will be necessary to capture sales and exchange data, calculate prices, and perform recalculations when any component of the price changes.

New systems or some elaborate tracking effort will be required to trace production from a federal lease to an affiliate's first arm's-length sale. Even with an expensive tracking process in place, 100% success will not likely be achieved.

Other rule requirements:

- Determine if oil was disposed of under a crude oil call; if so, determine whether the call is competitive or non-competitive

- Determine if sale was to opposing economic interests

- MMS to determine if value does or does not reflect "reasonable value" based on the proposed "breach of duty to market" obligation.

Reporting Valuation - Non-Arm's-Length Contracts

- The same tracing requirement must be undertaken as per above to be able to demonstrate whether or not production was sold by a company or its affiliate either arm's-length or non-arm's-length.

- In the Rocky Mountain Area (RMA), any tendering program must be approved by MMS.

- In the Gulf of Mexico, California, and Alaska, the net back method still does not work for the reasons enumerated in the previous COPAS comments.

- You must determine the nearest market center and crude oil most similar in quality to your oil.

- If MMS makes determination that index prices no longer represent "reasonable value", the MMS may establish "reasonable royalty value" based on "other relevant matters".

Reporting Transportation and Differentials

- Determination of a transportation allowance under a non-arm's length transportation arrangement is extremely burdensome as opposed to using FERC approved tariffs. Data may not be obtainable from affiliate pipelines.

- Quality adjustments when using index pricing raise the question as to where premia/penalties by pipelines with quality banks are determined--at intermediate commingling points, at aggregation points or at the market center that applies to the lease.

General Reporting

As a result of different valuation methodologies for different geographical areas, payors may need to modify computerized reporting systems to process and report royalties for different geographical areas.

- Payors and MMS may need to realign payor code and Accounting Identification (AID) numbers, in order to segregate the different valuation methodologies for statistical and audit purposes.

- Payors must review all instances where they remit royalties for a co-owner, to determine if the payor has the information necessary to continue reporting on behalf of others. It is our belief that most payors will discontinue reporting for others as a result of the complexity of the regulations. The proposed regulations make it impossible to accurately determine the royalty obligations of others. COPAS anticipates MMS will see an increase in the number of payors currently filing royalty reports.

- The information necessary to complete MMS Form 2014, Report of Sales and Royalty Remittance, will increase significantly. Information required under this proposed rule to value the product including product price, exchange differentials, and transportation deductions will greatly increase over the current rules. For further discussion please refer to the comments of the Barents Group in the comments filed by Gardere & Wynne dated March 6, 1998 concerning the Form MMS 2014.

Form MMS 4415 - Information Collection

Form MMS 4415, Oil Location Differential Report, required under the proposed rule to capture exchange differentials on exchanges involving Federal crude is a costly report to prepare. The following information, necessary to complete this report, is not readily available:

- Exchange contracts are in the custody of an affiliate or separate department not directly involved in the royalty process. The entity controlling the documents in most cases will not be able to identify the contracts covering Federal leases. An extensive manual effort or a sophisticated computer system will be required to identify the relevant contracts.

- Reviewing contracts to obtain requested information would result in a time consuming manual effort.

- Managing the data to complete the form will also be labor intensive or require computer programs.

- Refer to Barents Group's report on Form MMS 4415 in the comments filed by dated March 10, 1998 for additional information.

Audit Compliance Costs

Audit compliance costs will drastically increase as a result of several factors:

- Maintaining documentation to support valuation methodology; including cost of computer programming and storage of hard copies

- Maintaining documentation to support Form MMS 4415; including cost of computer programming and storage of hard copies

- Because royalty calculations will rely on so many factors, the number of prior period royalty adjustments will increase substantially; likewise document storage and audit costs will increase

- MMS must verify Form MMS 4415 data to ensure that data reported is correct and has been applied correctly to royalty payments. Additional audit staff and computer programming costs will be required

- MMS must determine that all exchange data that should have been reported was actually reported.

- Additional audit staff may be required as the proposed rule adds more complexity and uncertainty to the royalty valuation process

- MMS must verify the correct application of geographical pricing. Additional audit staff and computer programming costs may be necessary

- MMS may require computer programming changes to perform exception processing on a geographical basis

- Additional audit costs would be incurred due to the elimination of the use of FERC tariffs

As mentioned, this does not represent the sum total of provisions in the rule that will be costly to both the MMS and Industry, but these will certainly be significant cost drivers. Quantification of the above would vary by large, mid-size, and small companies, but one can easily conclude that the administrative burden being placed on all of industry and the MMS is extreme and unwarranted.

The proposed rule is complex and it will be very difficult for industry to decide which section of the rule to apply. However, if and when the proposed rule becomes effective, a company will have to attempt to decide which section of the rule to apply after thoroughly looking into how it conducts business for each and every transaction. A company may end up applying different sections of the rule to different transactions. This may change month to month. Then, the appropriate records to support that decision must be kept. Years later, the MMS audit staff would be able to audit and second-guess the company's decision as to how the rule was applied or how the lessee chose to market.

In general, this proposed rule would add an additional audit burden to the MMS. The MMS would have to greatly increase their audit staff to effectively monitor this proposed complex rule. Additional training would be necessary in order to prepare the auditors to review the complex methods and make decisions given the subjectivity in many areas.

Lack of Certainty

One of the MMS' reasons for a new rule was to add certainty to the valuation of oil for federal royalty purposes. However, this proposed rule only adds uncertainty. A paramount example is the requirement to trace barrels of federal oil. Barrels of oil are not color coded to identify where the oil was originally produced. There is not a color for federal, state, or fee oil. Simply put, the oil is commingled and then either sold or moved to refineries and may not be able to be traced at all. Many other examples express our concern have been cited in other areas of these comments.

Conclusion

In summary, MMS' supplementary proposed rule of February 6, 1998 continues to deviate from the Bureau's long history of determining value at or near the lease. In its dramatic departure from valuation at the leases, the MMS has created tremendous uncertainty regarding valuation. The complex methodology proposed and the lack of certainty combine to create an immense administrative and audit burden for the MMS and industry. COPAS recommends that the MMS adopt a workable benchmark system, based on arm's-length transactions at the lease, for valuation of oil produced from federal leases in all producing regions of the United States. Furthermore, as a long-term solution to valuation disputes, COPAS urges MMS to work with industry to develop and implement a comprehensive royalty-in-kind program.

Again, COPAS appreciates the opportunity to provide comments. If you have any questions or wish to further discuss these comments, please let me know.

Sincerely,

W. L. Stone

For: John E. Clark
Chairman, COPAS Federal Affairs Subcommittee

cc:
John Bowen
Scott Cailteux
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